BASEMENT

MASSACHUSETTS INSTITUTE of TECHNOLOGY
LIBRARIES

Digitized by the Internet Archive
in 2011 with funding from
Boston Library Consortium Member Libraries

http://www.archive.org/details/metamorphosisofg00ecka

DEWEY

HB31
.M415
no.95-22

working paper
department
of economics

THE METAMORPHOSIS OF GIANTS:
CHINA AND INDIA IN TRANSITION

Richard S. Eckaus

95-22 March 1995

massachusetts
institute of
technology

50 memorial drive
cambridge, mass. 02139

THE METAMORPHOSIS OF GIANTS:
CHINA AND INDIA IN TRANSITION

Richard S. Eckaus

95-22 **March 1995**

MASSACHUSETTS INSTITUTE
OF TECHNOLOGY

NOV 14 1995

LIBRARIES

THE METAMORPHOSIS OF GIANTS: CHINA AND INDIA IN TRANSITION[1]

Richard S. Eckaus[2]
Ford International Professor of Economics

Department of Economics
M.I.T.

March 20, 1995

I. Introduction

Three great economic transformations are taking place now in the world: in China, in India and in Eastern Europe and the former Soviet Union. These three transformations are of enormous importance. China and India alone have about 40 per cent of the population of the world. The countries of Eastern Europe and the former Soviet Union add almost another 10 per cent. So the economic fate of roughly half of the world's population is at stake in the changes that are underway. The changes are intellectually exciting, as well as intrinsically significant. As we watch China, India and the former Soviet Union move toward freer market economies, we will learn more about what is essential and what is idiosyncratic about established market economies and how economic and social systems change.

The transformations in process in China and India present many puzzles and paradoxes. While there is no single, overarching theory that will explain all of these, examination of the pieces of the pieces of the puzzles will provide some insights. For this purpose an even dozen of the influences on developments in the two countries will be scrutinized. Some occasional comparisons will be made to the former Soviet Union.

II. The Setting

At the end of World War II and after the revolution in China and achievement of independence in India these countries broke their old patterns of stagnation and set out on new paths of eco-

nomic growth. A comparison of the economic experiences of the first thirty or forty years in the two countries is difficult, because of their very different economic systems, intellectual traditions and approaches to economic statistics. Relying on the opinions of experts, among whom there is some disagreement, it appears that in the early 1950's both countries were at about the same per capita income levels.[3] Subsequently, the economic growth in both countries was a distinctive and remarkable break with the past.

In the 1960's, despite the differences in their systems and in the economic fluctuations they had experienced, the Chinese and Indian average per capita incomes were still not so far apart. According to the best estimates that try to take into account the different domestic purchasing powers of the separate currencies the Chinese per capita gross domestic product in the early 1960's was even slightly lower than that of India.[4] At the end of the 1960's neither country had achieved the kind of economic breakthrough that had already started to occur in the rapidly industrializing countries of Asia, the four tigers of Hong Kong, Korea, Taiwan and Singapore. India's economic growth actually slowed down in the late 1960's, while China's growth accelerated and, by 1970, the Chinese per capita gross domestic product was distinctly higher than that of India. Subsequently the Cultural Revolution caused a major slowdown in China, But the Indian economy also grew sluggishly through most of the

1970's at, roughly, 3 per cent overall, in real terms, or about 1 per cent per capita, what one prominent Indian economist called, "the Hindu growth rate."

In 1978 China started on a extraordinary economic advance that has continued to the present with only brief slowdowns in 1981, 1985 and 1989-90. From 1978 to 1993, the average annual growth rate of real GDP was 9.4 per cent. In 1992, the overall growth rate reached 12.5 per cent; for 1993 it has been estimated at over 13 per cent and the pace seems to have been almost maintained in 1994. It is difficult to convey how extraordinary the growth record of these recent years is. There are few countries that have ever achieved growth rates over 10 per cent per year, even in the periods of their most rapid development.

In India, on the other hand, from 1980 to 1990, the average rate of growth of real GDP was about 4.5 per cent, with occasional accelerations during the late 1980's to the 5 per cent range. In 1991 India faced a severe macroeconomic and balance of payment crisis that forced a retrenchment from which it recovered only slowly. That has reduced the average annual growth rate since 1989 to about 4 per cent. Thus, China definitely moved to a new growth trajectory in the late 1970's and accelerated in the 1990's, whereas India has fallen far behind.

Some skepticism about these comparisons is warranted, because there may be significant mistakes in the data on which they are based. For example, it is quite possible that part of agri-

cultural output was not reported before the "household responsibility" system was created in China. Underreporting would make it possible for the villages to retain more of their output for their own use.[5] The incentive was removed when households were allowed to retain their output in excess of their delivery quota. The area of greatest suspicion is in the treatment of price changes. The rate of inflation in China has been quite substantial in the last 15 years or so and there have been drastic changes in relative prices. Both types of changes are difficult to treat accurately, in the best of circumstances.

By comparison, we know a great deal about the manner in which the Indian national income accounts are constructed, but there may be errors there too. There is almost general agreement that in India, as well as China, there is a significant underground economy that is simply not measured. Failure to take account of its growth might explain some of the reported relatively slow growth of the Indian economy.

III. Explanations of the Relative Success of the Chinese and Indian Economic Reforms

Three categories of reasons will be examined for the differences in the economic performance of China and India: first, a few aspects of each country's particular combination of history and institutions, second, resource availabilities and technologies, and, third, economic policy. Since social and economic influences interact, the hypotheses to be presented do not all

fall neatly into one or another of these categories. For example, there are underlying causes for differences in investment patterns and the use of technologies. Although the proximate cause may be in some policy that has been adopted, the adoption of the policy, itself requires an explanation.

(1) The history and culture of China has made it particularly receptive to market capitalism.

One of the most commonly voiced hypotheses for the relative success of the economic reforms in China ascribes that success to its special culture and social character.[6] The Chinese are often described as essentially "capitalist" in character, natural merchants, who have in their basic character the qualities of capitalist entrepreneurship: to seek out economic opportunities, to buy and sell and calculate profit margins.

The characterization is reminiscent of arguments of the 1950's, when it was common to reverse the hypothesis for developing countries as a whole. The lack of capitalist entrepreneurship was then widely regarded as the most difficult obstacle that developing countries had to overcome.[7] Many Ph.D. dissertations were written then about the scarcity of entrepreneurship in developing countries. One of the lessons of development of the last thirty years is that lack of entrepreneurship is for the most part associated with lack of opportunities. In general, when people are given education and economic opportunities, they take advantage of both. The Bengalis, the Gujeratis, the

Maharatis, and so on of India do not need lessons in entrepreneurship.

Interestingly, national character and culture are also sometimes used as an explanation of why economic reforms in the former Soviet Union have moved relatively slowly. The argument is that there never was much of a culture of entrepreneurship and wage labor in Czarist Russia and that the 75 years of communism have destroyed whatever there was. The explanation overlooks the history of the successful peasant kulaks and aggressive Russian merchants and industrialists, who took advantage of the commercial opportunities that emerged in Russia in the late nineteenth and early twentieth centuries.[8]

(2) The Indian bureaucracy has obstructed and the Chinese bureaucracy has supported the economic reforms

The next conjecture about the reason for the relatively fast pace of the Chinese economy is that the Chinese bureaucracy and Communist Party structure have supported, while the Indian bureaucracy and many of the political insiders have opposed their economic reforms. In the former Soviet Union the bureaucracies and old politicos, the nomenklatura, have also generally been in opposition to market reforms. In all three countries, the economic reforms have their origin and need the support from the government sector. So the unofficial as well as official postures of the government are important, if not crucial, factors.

At the time of independence, the Indian bureaucracy was widely regarded both as honest and as one of the most effective in the world. Indeed, the persistence of the system of extensive economic regulations may have, in large part, been due to the unusual ability of its bureaucracy to make its cumbersome system of economic regulations work at least moderately well. However, it is now widely believed, both within and outside of India, that the bureaucracy has been corrupted by the system it regulated, selling to the private sector many of the privileges created by the regulations.[9] India, in fact, is often regarded as the paradigm of the "rent-seeking" economy in which private firms devote substantial resources to pursuing the "rents", that are the special economic returns from the particular privileges created by extensive regulation. If the rents are, in fact, important, then it is likely that the pay-offs to the bureaucracy and political insiders have also been important.[10]

In the former Soviet Union the nomenklatura did not benefit from the system it controlled by selling privileges in a market economy, but it did profit from its special position. The dachas, the special summer resorts, access to the restricted food shops, advancements for their children, and so on were important privileges.

The government bureaucracy and the Party members in China also enjoyed some special privileges, before the market reforms, but their circumstances were, nonetheless, rather different. The

beginning of the economic reform period came quickly after the end of the tumultuous period of the Cultural Revolution and after the reversal of many policies and personnel appointments. Thus, whether because of relative honesty, greater disillusion or a shorter period within which to consolidate their privileges, the Chinese bureaucracy had fewer commitments to the old regime of government economic controls.

Reforms that eliminate government controls also eliminate the rents that the bureaucracy can appropriate from distributing benefits. Such reforms even destroy the rationale for much of the bureaucracy that administered the regulatory system. So the reforms attack the very raison de entre' of many of the bureaucrats. It is, therefore, understandable that the Indian bureaucracy would oppose such reforms. Likewise, market reforms and the associated political reforms in the former Soviet Union have also eliminated the rationale for much of the bureaucracy and threaten the privileges of the old politicos. Although market reforms threaten some parts of the Chinese bureaucracy, because of fewer prior commitments, the Chinese bureaucracy has been more easily corrupted by the market forces that have been unleashed.[11] That has converted them into supporters of the reforms and high speed growth.[12]

(3) The fast growth in China is largely the result of the elimination of the gross inefficiencies of the previous system.

There is, no doubt, some truth in the argument that at least the initial successes of the reforms in China were, to a large

extent, the result of the elimination of some of the large and pervasive prior mistakes and inefficiencies. The enormous success of the initial reform in agriculture is, perhaps, the prime example. In 1978, in order to help a particularly poor region, the authorities in a single province began the experiment of substituting individual household responsibility for collective production. Incentives were created by allowing households to keep their surplus output, which stimulated subsequent, very large increases in production. With the approval and support of the central government, the reform was copied throughout Chinese agriculture.

There are many other examples in China of rapid success in making up obvious deficiencies. Under the Communist planning regime the Chinese economy, like the economies of the former Soviet Bloc, was starved for many ordinary services, from clothing and house repair to retail shops. The provision of these services does not require much capital and the skills are often easily available. So, after the reforms made increased production of services possible, the expansion of this sector has been fast and relatively easy and has filled an major void in the economy. Yet, although there is certainly some truth to the argument that China has moved fast by removing some of the most flagrant obstacles to economic efficiency, that does not explain the continuing fast growth over a number of years. Changes of this type are once-and-for-all and do not explain the continuing fast growth over a number of years.

By comparison, India has always had a great deal of scope for private initiative in agriculture, in services and other sectors. So there are fewer opportunities for quick gains, particularly in the private sector. That is not to say that there are none. There are still major inefficiencies created by the remaining regulations and in the state enterprises that could be eliminated by further reforms.

(4) The economic expansion in China is, to a large extent, due to the boom in China in cooperative enterprises created and managed at the local level.

The expansion of small scale, cooperative township and village enterprises (TVE's) in China has been one of the most astonishing features of its economic reform. The real gross output of these enterprises grew at the astounding rate of 30 per cent per year from 1985 to 1992. There is no counterpart to this explosive growth in India.

The success of the TVE's has been credited to their community support and participation.[13] Yet they have often been heavily taxed and the benefits accruing to participants have not always been spread widely through their communities. Indeed, the taxation has been a major source of difficulty for some TVE's, as their revenues have been utilized in some communities as an important supplement to local taxation.

On the demand side, a plausible explanation for the TVE phenomenon is that they have simply moved into the vacuum created

by the inefficiencies and limited scope of the state enterprises. They are providing goods and services that have been inadequately supplied or completely neglected in centrally planned economies. On the supply side, part of the explanation for the remarkable success of the TVE's is the prior, widespread distribution in rural areas of small scale handicraft and industrial skills. While the Great Leap Forward was an enormous human disaster, it nonetheless left a residue of such experience. It is also possible that the pre-reform concentration on heavy industry and the inadequacies of the transport system had stimulated local dependence on small scale production that provided a basis for subsequent, post-reform expansion.

The absence of a comparable fluorescence of small industry in India in response to its reforms may be explained in two ways. First, there was a rapid expansion of the Indian private sector in the 1950's and 1960's, as new firms filled gaps created by new opportunities. We may now be seeing in China the analogue of that early Indian experience. Second, the Chinese small scale TVE experience may be a temporary phenomenon that the Indian economy has passed by. Although there is evidence that labor productivity in the TVE's has risen rapidly, there can be little doubt that a small TVE cement plant producing a few tons a day is simply not as efficient as a large plant would be. The TVE cement plant may do well at first because of production bottlenecks and inefficiencies in the larger state operated plants and in the

transport system. Yet, because there are undeniable economies of scale in cement production, the small plants will not be able to compete with plants of efficient scale. The same will be true in other types of manufacturing. It is, therefore, an open question as to whether the TVE's will survive, if either the large state enterprises or converted into efficient establishments, or as firms grow and consolidate.

(5) The simplest and best explanations of the differences in the economic performance of China and India are the higher savings rates and higher capital productivity in China.

Turning from culture and institutions to the relatively simple matter of the amount of resources devoted to growth, the most obvious first explanation of the high Chinese growth rates is in its high overall savings rates. These rates had already been relatively high, at about 30 per cent until the late 1970's when they begin to rise to forty per cent in the 190's. The Indian savings rates have also increased, but more recently and much more modestly from around 20 per cent in the 1980's to the range of 23 or 24 per cent. To help put the extraordinary Chinese savings rates in perspective, the savings rates of the Japanese and Swiss, two of the thriftier peoples of the world are 34 and 30 per cent, respectively. Small Singapore, an urban area with a much higher per capita income, is the only non-oil exporting country that matches the Chinese savings rate.

High savings rates make it possible to have high investment rates and those, in turn, make it possible to have high growth

rates. Whether the possibilities are realized depends on the productivity of the investment that the savings rates make possible. The overall productivity of investment in China and India seems to have been about the same for many years, but in the last few years China has gained an advantage over India in this respect. Even a slight difference, compounded over time, can generate big differences in wealth.[14]

The improvement in the productivity of China's investment in recent years is also unusual. Development economists might well have expected the reverse situation. It has often been true that there has been a kind of diminishing returns to the rate of investment, due to something called, "limited absorptive capacity." But that limitation has not as yet been important in China.

(6) The higher levels of foreign investment in China than in India are an important part of the explanation of the differences in their performance.

Foreign funds supported a much smaller share of investment in China than in India for most of the period since the end of World War II. From the beginning of the Chinese economic reforms, private foreign investment in China has grown rapidly and became more important than in India. It is difficult to be precise about relative magnitudes due to lags in reporting, differences in the details reported and the differences between commitments and actual investments.[15] According to World Bank data,

however, long term capital inflows to China in 1993 were US$ 33 billion, while for India they were US$ 10 billion. Foreign investment in India has started to increase in the last two years and it is possible that a fundamental change in past patterns may be beginning.

It is something of a puzzle as to why foreign investors have preferred China to India. Although Indian politics is as unsettled as in many democracies, Indian democracy has survived many challenges and remained strong. By comparison, to many observers the future course of the Chinese political system seems relatively unclear, so political uncertainties that influence economic calculations would seem to be less important in India. India has firmly established and relatively familiar legal system, with protection of private property rights and clear, if restrictive rules for the payment, hiring and firing of labor. The Indian tax system is also well defined and, although rates may change, there will be no great surprises. By comparison, the protection of property rights and contracts in China and its tax regime are still evolving and there have been unfavorable surprises.[16] The Indian financial system is more extensive and more experienced than that of China, which is still rudimentary. India has more engineers than any other country and has the advantage of wide use of English in the work force, whose average wages are as low as in China. All this and yet foreign investors have been relatively reluctant to invest in India as compared to China.

There are several components to the explanation of the puzzle. First, success breeds success. China is growing faster than India. Still, the Indian market is more than large enough to be attractive to foreign investors, if only Indian economic policy was receptive. But it has not been consistently so. China now offers rapid clearances for foreign investment, preferential tax rates, duty free imports for exported goods, guarantees for profit and royalty repatriation, and special permissions to dismiss labor. Until recently in India it has been a long and tedious process to obtain government approvals for foreign investment. It is now reported that procedures have been reformed and approvals go through in fifteen days or less in "deregulated" areas, with few rejections. But the regulated areas are still quite broad. Moreover, there is a well-known recent case of a major U.S. firm being hounded out of an approved investment by an outcry raised in Parliament. On the one hand, the Indian government has announced the opening of oil exploration and mineral prospecting and mining to private, including foreign investors. On the other hand, Indian parliament members promise to drive the, "advance guard of American capitalism," Coca-Cola and Pepsi, out of India.[17] So the prospects for foreign investment in India may still appear somewhat unsettled.

The commitments by the Chinese emigre' populations in Hong Kong, Taiwan and Singapore help explain the relatively large private investments in China. Though these are sometimes explained

by their special attachment to their origins of the Chinese living abroad, as compared to emigrants from other countries, personal or family knowledge of conditions in China and command of the language is a simple alternative explanation.

(7) Economic reform has been a clearer and more definite commitment in China than in India.

This is one more paradox in the comparison of China and India. Private enterprise and cooperative endeavors in pursuit of profit were anathema in China for many years. So an absolutely firm government commitment to reform policy seems to be essential an essential requirement to induce both domestic and foreign private or cooperative enterprises to undertake investments. Yet, given the opacity of the political system, it would appear to be difficult for an outsider to be completely convinced of this commitment. Moreover, there have been occasional slowdowns, if not reversals, in the movement toward a market economy and occasional inconsistent public statements.

The political uncertainties are reflected in the stories about the decisive role in China of the Communist Party elders and the obscure competition for leadership among the next generation. The effects of that political process on the final shape of economic reform policy are uncertain. If these concerns are taken seriously, and there is no other way for outsiders to take them, the political climate in China would seem to provide a dubious basis for long term plans.

Yet that does not seem to be the case. Rather, the commitment to economic reform has been regarded by foreign investors as firmer in China than in India. That might be explained by the fact that in India the current reforms are being put in place by a minority government. That might as well be interpreted as evidence of general support, since the reforms could be relatively easily blocked by a determined opposition, but it could also be interpreted as evidence of the tenuous political basis of the reform program.

It is often pointed out that the time span of the Chinese reform program, which started in 1978, is much longer than that of the Indian reforms. It is true that, until 1991, the steps toward reform in India were small and tentative. On the other hand, the transformations in India, although of great significance, are certainly less wrenching than the policy reversals in China. Perhaps it is the openness and vehemence of the political debate in India that explains the paradox.

(8) In China much of the decision making with respect to reforms has been decentralized and many of the reforms have originated at the regional and local level. In India the reforms have originated and been propelled by central government actions, often with local government resistance.

This is still another somewhat paradoxical difference. It is only partially resolved by the realization that control of the Chinese economy has not been highly centralized in Beijing for

many years. Immediately after their successful revolution, the Chinese Communists were instructed by and emulated the centralized Soviet system in their approach to the direction of their economy. This tutelage was shrugged off as the result of Mao Tse Tung's distrust of the Soviet Union and, as well, of concentrated bureaucratic control. Another consequence of this distrust was the devolution of economic power from Beijing to the provincial governments in a series of policy moves beginning in the late 1950's. There were partial reversals in this devolution at various times, but, by 1978, the provinces held a great deal of economic power, including the power to undertake major innovations.

The Chinese provincial authorities have been extraordinarily eager to introduce market reforms, appearing to try to outdo each other in this respect. Three conjectures will be offered in explanation. The first is that the transfer of power to the provinces that started not long after the Chinese revolution has generated both a feeling of confidence and the reality of competence in the local governments. The second reason is that some of the important steps in the market reforms, in particular, the household responsibility system in agriculture, originated in the provinces. The special economic zones, administered by provincial authorities are also one of the great successes of the reform program. So the provincial authorities could, in effect, claim to be the chosen instruments of reform. Finally, the success of the provincial economies leads to higher tax collections

and greater independence from the central government in Beijing in carrying out local projects.

By comparison, the Indian states have had less scope for individual action. The Indian system, for example, has not allowed the states to set their own rules for investment, either domestic or foreign. So the initiatives had to come from the center. Moreover, although it is beginning to change, there are a number of states with governments with histories of ideological opposition to market capitalism that have not made the Chinese transition. In addition, political opposition and communal hostility in states that might have been expected to be growth leaders, such as the Punjab, have created uncertainties that have distracted potential economic reform movements.

(9) The reforms have been piecemeal in both China and India, rather than a "shock" treatment, but China has experimented with a wider range.

Both China and India have adopted a kind of "installment payment" approach to reform, rather than an economic "shock treatment." The step-wise process of reform in China is partly a consequence of the local origins of many of the reforms, but it is also part of the overall strategy of Chinese reform, which has been pragmatic and experimental. China has consciously adopted the pattern of trying out particular types of market reforms in restricted areas and then abandoning or generalizing them, depending on their success. The special economic zones, the lo-

cal stock markets, the free trade areas, the opening of specific sectors to foreign collaboration and, perhaps, most importantly, step-wise deregulation of prices, are all examples.

The "dual track" price system, that was adopted with the intention that it evolve into a single price system, as, in fact, has been happening, is an important aspect of China's incremental approach. A set of official prices was maintained for many commodities, including many of the goods produced by state enterprises, at the same time as market determination of prices was allowed for some share of the same commodities, and other prices were set completely free.

Although it is important that an economy be guided by real scarcity prices, it is also true that there are major adjustment costs in moving to such prices and that these costs can endanger the success of the transition process. The dual price system created the potential for diversion of goods from one market to another, with consequent inefficiency in resource allocation and creation of opportunities for corruption, but it also lessened those stresses, as the range of price decontrol was slowly extended.

"Muddling through" in China has not eliminated the inefficiencies and deficits of the public enterprises, but it has reduced their significance. It can be argued that this only delays the necessary adjustment to more efficient methods of production and distribution, but there are also other constraints

that have delayed the transition. So the slow price adjustment may not mattered very much.

The reform process in India has also been an incremental one, for some analogous and some different reasons. Although Indian reforms may be thought of as being simply a broadening of the scope of existing markets, they also require painful adjustments. Because of the openness of its political processes, we can also see the political forces that line up against economic reform more clearly. These include protected domestic enterprises as well as ideological opponents to market capitalism and both bureaucrats and labor unions who fear the loss of protected markets and special benefits. The tenuous Parliamentary majority of this Indian government is the best explanation of its slow movement, but it is plausible that this would be true of any government in a democracy, except one elected by a landslide to do the reforming, which is certainly not the case in India.

The relatively slow pace of reform in India reflects divisions in the country with respect to economic liberalization, one aspect of which is the growth of individual and regional income inequalities. That has produced the slogan of, "continuity with change." In India this has been interpreted as, 'go slow." There are similar slogans in China, however their meaning seems to be some nostalgic commitment to the past. They certainly do not mean, "go slow."

Price reform is also important in India. Subsidized prices in the large public sector establishments have often been used to

subsidize particular regions and sectors of the economy. Price regulation in agricultures has distorted farmers incentives. But India also has a large private sector in which some prices have been determined by market forces. Although it has preserved inefficiencies, by moving deliberately, the Indian government has largely avoided the public anger and bitterness that rapid change has evoked in the former Soviet Union.

(10) Neither China nor India have made significant progress in privatizing their public enterprise, but China may have been more successful than has India in increasing their efficiency.

Public enterprises in both China and India suffer from endemic inefficiency. That, in turn, has created a need for subsidies that are a major drain on the government budgets. In both countries the governments have announced intentions for extensive privatization, but in neither country have the intentions been followed by actions that have been very effective in reducing the subsidies.

In China, in the "enterprise responsibility system", the output targets of state enterprises have been transformed into profit targets. The precise level of the targets are, apparently, the result of a kind of bargaining process between ministry representative and the officials of each public enterprise. Higher wages, bonuses and access to investment funds are the "carrots" which the ministry representatives use to induce better management. It is difficult to know what "sticks" may be applied

in the bargaining process. The Chinese procedure is clearly open to abuse and, at best, is far from the incentives of a free market. Yet it has been partially successful in creating pressures for increased efficiency, though not enough to substantially reduce the burden of subsidies.[18]

In India, most public enterprises have been converted into corporations which, nominally, have considerable independence in seeking to maximize their profits. In many cases a minority fraction of the total equity has been sold into private hands. Though partially successful, as in China, it has not led to general improvements in efficiency,, as shown by the continuing low profits or substantial losses of the enterprises.[19]

(11) The willingness and ability of the Chinese and India governments to control inflation continues to be tested with India currently showing more success.

Macroeconomic policy is a critical ingredient in the catalysis of economic growth and both China and India have been quite sensitive in this sphere of action. The bursts of ebullience of the Chinese economy after the start of the reform program has led to successive balance of payments problems and inflationary pressures. There have been four such episodes from 1978 to the present: in 1981, 1985, 1988-9 and currently. Each episode, up to the present has been followed by rigorous remedial deflationary policies. In the first three cases, the deflation was effective and the recovery and resumption of rapid growth was

quick.[20] The current episode of inflation may be dated as starting in 1992 and has lasted longer and been more severe than the previous episodes. The inflation rate in 1994 is now officially reported to have been 22 per cent, with a high of 27.7 per cent in October, 1994.

Early in 1993, as inflationary pressures became obvious, Zhu Rongji, formerly mayor of Shanghai, was appointed as vice premier and given the task of controlling these pressures. This decision was, presumably, influenced by the experience of the Tiananmen Square protest in 1989, which was widely regarded as a partial consequence of inadequate control and inequitable adjustment to inflationary pressures. A number of important actions followed Zhu's appointment. These included the reorganization of the central bank and establishment of effective control over the provincial branches. In the past, the credit facilities of the provincial banks have expanded under the pressure of local government and political officials, helping to provide the monetary base for the inflationary pressures. The provincial bank control measure was supplemented by a State Council order halting major new investments in fixed assets, presumably because it was believed that credit policy would not, by itself, be effective. The new tax laws inaugurated at the end of last year also give the central government increased powers to deal with inflation.

The limitations on credit to state enterprises in July of last year were reported to have been abandoned after several

months of complaints. In early November of last year Deng Xiao Ping was quoted as saying that, "Development at a slow pace is not socialism." Zhu Rongji was reported at that time to have, "faded from view."[21] Yet he continues to be quoted in support of controlling inflation. At the end of January, the State Council was reported to have "reissued" its ban on new investments in fixed assets, implying, first, that the ban issued in July of 1993 had not been fully effective and, second, a renewed determination to control inflation. Announcements of the extensions of the ban were repeated through 1994 and limitations on state enterprise credits have been reimposed.

The different interests in Chinese official circles with respect to the rate of economic expansion help explain the conflicting signals with respect to the Chinese government's commitment to fighting inflation. As an indication of the internal debate, there have been accusations that the Chinese Politburo had kept from the public the remarks by Deng Xiao Ping encouraging more rapid economic development. This was done, it was alleged, because of fears that the remarks would, "exacerbate divisions within the party and contradictions between the center and the regions."[22]

The side in favor of slowing the economy to dampen inflation appears to be led by Zhu Rongji, but behind him are those party and government officials who were powerful enough to put him in place. Although apparently not in the Rongji circle, Prime Min-

ister Li Peng, supported vigorous action against inflation in his speech to the National People's Congress in March, 1995, which also made a veiled criticism of the responsible parties who had not successfully controlled inflation. Outsiders cannot know how to count the votes on this issue or even if there are votes.

This is a critical moment in the Chinese reform program. Apart from the political consequences, the lessons of history tell us that excessive inflation can become a major obstacle to real development. What constitutes "excessiveness" in inflation is hard to say, since there are countries that have managed sustained growth with inflation rates of 20 per cent or more. These countries have evolved ways of adjusting to inflation that do not now exist in China.

By comparison, over most of the past twenty years India's record in limiting inflation has been more consistent than that of China, with price increases averaging around 7 per cent per year until 1990. In that year inflation was slightly over 10 per cent and reached almost 14 per cent in 1991, before falling to 10 per cent again in 1992 and to about 8 per cent in 1993.

The recognition of a balance of payments and inflation crisis in 1990 and 1991 brought the present government into power and provided the immediate rationale for structural reforms as well as changes in macroeconomic policy. Yet, the political weakness of the government has limited its ability to adopt unpopular deflationary policies.

The IMF agreement, under which India has operated for the last several years, is an official commitment to reduce inflation, with the IMF watchdogs watching closely. There has been considerable success in reducing the balance of payments deficits since 1990, when the current account deficit was over 3 per cent of the gross domestic product. A sharp devaluation of the rupee and changes in foreign exchange policies to give greater incentives to exports has stimulated exports and reduced imports. In the past year the balance of payments deficit has been reduced to one sixth of the 1990 value. The government budget deficits have been reduced sharply and inflation rates have come down to about seven per cent in early 1993 before moving up again to ten per cent in late 1994.

(12) The growth in China relative to that in India and the former Soviet Union is due to China's choice of "perestroika" before "glasnost", i.e., economic decontrol before greater political latitude?

This proposition reflects one of the great issues of social policy, debated with respect to China and India, debated in the former Soviet Union, debated with respect to many of the developing countries of the world. It is, for example, a favorite theme of the former prime minister of Singapore, Lee Kuan Yew, who is apparently credible because of the economic success of Singapore. He frequently argues that democracy and the transition to successful economic development are not compatible, that economic

transformation must come before political liberalization.[23] Yet, the experiences of China and India furnish little illumination on this grand question. They are just two sets of observations and the list of other factors that have contributed to the differences in their economic success is a long one.

Before taking up the proposition, it will be useful to deal briefly with one other, related matter. Without diminishing the real concerns about civil liberties in China, it cannot be denied that there is now much more personal freedom in China than before the economic reforms started. It remains circumscribed and attacks on the political system are still suppressed, although more in some regions than in others. In most other respects the scope for freedom of choice and behavior has expanded greatly and not just in what might be called the tokenism of dress codes. Thus, it cannot be maintained that the economic reforms in China have proceeded against a background of unchanged and unrelenting suppression of individual liberties.

Was it necessary for its economic success for China to allow more personal freedom and will further economic success make a successful transition to wider political freedoms more likely? It has been argued that the policies that reduced the interdictions in personal behavior and introduced the economic reforms were a reaction to the constrictions and convulsions of the Cultural Revolution.[24] A plausible case can also be made that the expansion of personal freedoms was essential to make the economic

reforms effective. Peasants might not have responded so positively to the household responsibility system, if they could not have used their additional income to build better housing, eat better food and wear better clothing, none of which was assured during the darkest days of the Cultural Revolution. After those oppotunities come personal radios, television, the migration of their children to cities and the beginnings of changes in lifestyles. It might also be argued that the entrepreneurial freedom that has generated the efflorescence of the TVE's and private enterprise, often with foreign participation, could hardly be confined to the business world. As to whether the economic reforms will lead to more political freedom, that goes beyond the experience that has been observed and history does not provide a sure guide.

What does Indian development tell us on this question? Rather little. India became a democracy with independence and has never placed itself in a position in which a choice had to be made between openness and economic development. The institutions of Indian democracy have been strengthened by time and severe tests. The current reform government, which is relatively weak, in terms of its parliamentary margins, took power after an assassination that might be interpreted as creating political uncertainty, but that uncertainty was not about the continuation of democracy in India. It is this weak government which is carrying out the reforms that stronger governments could or would not.

This, undoubtedly is to some degree responsible for the careful pace at which the reforms have been introduced. The Indian experience does tell us, first, that democracy does not insure rapid growth and, second, that, in the perplexing way that democracies sometimes work, weak governments can become the instrument of strong reforms.

The following is true: economic liberalization of a rigidly regulated system, although it benefits everyone, on the average, will hurt some people and create uncertainty among a great many. Thus, in order to carry it out successfully, the people must believe in the government's promises and the government must be legitimate in this sense. For different reasons that has been the case in both China and India. While the Tiananmen Square events were said by some at the time to have destroyed to the legitimacy of the Chinese government, that has not been the case in the sense that its people have become inert or uncooperative or have stopped participating willingly in the reform programs.[25]

IV. Postscript

It is too early for a final judgment on the relative contribution of all of the elements in the reform programs in China and India and, for China, there may never be enough data to permit a reasonably firm conclusion. There are also still major, though different obstacles to overcome in each country before economic victory can be declared. In China the transformation of the economic system has far to go and many problems remain to be dealt

with, for example: the inefficiency of the public enterprises, the entanglement of household consumption decisions with employment, for example in the provision of housing, the need for a comprehensive banking system and the provision of set of laws that detail property rights.

Although the transformation in India not so profound, it too is a major reshaping of the economy. There are ingrained habits of xxx inherited from colonialism that have never been purged from the bureaucracy. There are fierce disagreements over central elements in a reform program, such as the protection of scheduled caste privileges and the extension of important public responsibilities, such as compulsory education. India, too, has to convert its public enterprises and change its labor laws, its price controls and production regulations.

There is too much to summarize and the discussion above warrants no general conclusions, but, rather a reprise: the changes underway in China and India are singular events. They are momentous and intellectually fascinating and deserve continuing careful attention, for themselves and for what they may reveal about the essence of market economies.

1 The XIII Eckstein Memorial Lecture, Center for Chinese Studies, The University of Michigan

2 I have benefited from the scholarship of many others, who, of course, have no responsibility for the manner in which I interpreted their work. On the reforms in China, in addition to other works cited below, I should mention the work of A. Husain (1992), Yingyi Qian and Chenggang Xu (1993), and Zhiyuan Cui,(1993). There is less published material available on the Indian economic reforms, but the analysis of J. Bhagwati and T.N. Srinavasan (1993) and the Indian Ministry of Finance have been particularly helpful. I am also indebted to the excellent assistance of Christiana Stamoulis in elucidating some of the data.

3 See Subramanian Swamy, (1979).

4 See R. Summers and A. Heston, (1991).

5 During the Great Leap Forward, the pressures to appear to be achieving Mao's quite unrealistic goals led to reporting of output gains just as a severe drought was drastically reducing output. This contributed to the devastating famine of the late 1960's.

6 See, for example, K. Chen, et al, 1992, p. 216.

7 See, for example, B. Higgins, (1959) Chap. 13.

8 See A. Gerschenkron (1951).

9 There are no surveys of bureaucratic practice to support or invalidate this view. It is simply the stuff of countless stories of dealing with the government.

10 A.O. Krueger (1974), p. 294.

11 There are incessant official campaigns against government corruption. Reformers outside the Party and the government have also made this an issue. The capital punishments imposed are officially justified in terms of the dangers to social stability and the success of the economic reforms created by corruption.

12 Although these characterizations of the Chinese and Indian bureaucracies are pervasive, there is also general agreement that there are many persons of dedication and integrity in both systems, as, presumably, there were in the former Soviet Union.

13 See M.L. Weitzman and Chenggang Xu, 1993.

14 Modigliani and Cao (1994) calculate that the large decline in public savings in China since 1978 has been offset by a similarly large increase in private savings. The latter increase, they argue, has ben stimulated by the rapid growth rates, which leaves a chicken and egg problem.

15 India does not officially report direct foreign investment.

16 The government decision in late 1994 to evict the McDonald's restaurent from its prize location near Tiananmen Square, in spite of a long term lease is a notorious example of such a "surprise".

17 Indian Parliament member as quoted in the Boston Sunday Globe.

18 See T.G. Rawski, (1993).

19 See J. Bhagwati and T.N. Srinavasan (1993), pp. 47-53.

20 See, R.I. McKinnon, (1993).

21 Wall Street Journal, Nov. 23, p. D6.

22 Reported in the China News Digest, March 5,1994.

23 Actually Lee Kuan Yew's proposition is one about transitions of countries from colonial, military or single party rule that are much less ideological and oppressive than the unreformed communist systems of the Soviet Union and China.

24 A.D.Barnett (1981), pp. 27-33

25 Another interpretation is that the Tiananmen Square protests were not against the reforms themselves, but rather against some perceived inequities in their administration.

BIBLIOGRAPHY

Barnett, A. D., China's Economy in Global Perspective, Brookings Institution, Washington, D.C., 1981.

Bhagwati, J. and Srinavasan, T., India's Economic Reforms, Ministry of Finance, India, 1993.

Chen, K., Jefferson, G.H. and Singh, I., "Lessons from China's Economic Reform," Journal of Comparative Economics, 16, 1992, 201-225.

Cui, Zhiyuan, "Muddling, Not Yet Through -The Implementation of Dual Track Price Reform," (to appear in P.N.S. Lee and S. Handers, eds. Reform and Policy Implementation in China, Oxford University Press, 1993.

Government of India, Ministry of Finance, Department of Economic Affairs, Economic Reforms: Two Years After and the Task Ahead, (no date).

Husain, Athar, "The Chinese Economic Reforms in Retrospect and Prospect," CP No.24, The Development Economics Research Programme, London School of Economics, August, 1992.

MIT LIBRARIES
3 9080 00940 0943

Jefferson, G.H. and Xu, W., "The Impact of Reform on Socialist Enterprises in Transition: Structure, Conduct, and Performance in Chinese Industry," Journal of Comparative Economics, 15, (1991), 45-64.

Krueger, A. O., "The Political Economy of the Rent-Seeking Society," American Economic Review, LXIV,3, June, 1974, pp. 291-303.

McKinnon, Ronald I., "Financial Growth and Macroeconomic Stability in China, 1978-1992: Implications for Russia and Eastern Europe," in The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy, Johns Hopkins University Press, 1993, pp. 187-216.

Modigliani, F. and Cao, L.S., "The Chinese Saving Puzzle and the Life Cycle Hypothesis," M.I.T. (unpublished), October, 1993.

Overholt, W.H., The Rise of China, W.W. Norton, New York, 1993.

Rawski, Thomas G., "Progress Without Privatization: The Reform of China's State Industries," in V. Milor, ed., Changing Political Economies: Privatization in Post-Communist and Reforming Communist States, L. Rienner Pub., Boulder, (1993).

Summers, R. and Heston, A., "A New Set of International Comparisons of Real Product and Price Levels: Estimates for 130 Countries," Review of Income and Wealth, XXXIV, 1988, pp. 1-25.

Weitzman, M.L. and Chenggang, X. "Chinese Township and Village Enterprises as Vaguely Defined Cooperatives," CP. No. 26, The Development Economics Research Programme, London School of Economics, Sept., 1993.

World Bank, China, External Trade and Capital, Washington, D.C., 1988.

Yingyi Qian and Chenggang Xu, "Organizational Basis for Economic Transition," Department of Economics and CEPR, Stanford University and STICERD, London School of Economics, September, 1993.

2554 28

Date Due

NOV. 25 1992
AUG 2 0 1999
DEC 0 3 2002
NOV 1 7 2004
DEC 1 4 2004

Lib-26-67